APPENDIX

[1] **Opinion of the District Court**

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

Civil Action No. 2787

SAMUEL MELTZER, *Plaintiff*,

v.

ARCH C. SCURLOCK, et al, *Defendants*.

Alexandria, Virginia
May 29, 1963

Before:

HONORABLE JOHN D. BUTZNER, JR.
United States District Judge

[2] Appearances:

NATHAN D. LOBELL, ESQ., and
GEORGE GIAMMITTORIO, ESQ.,
Counsel for the Plaintiffs

ARMISTEAD BOOTHE, ESQ., and
GANSON PURCELL, ESQ.,
Counsel for Defendant Arch C. Scurlock

CHARLES S. RHYNE, ESQ., and
THOMAS P. BROWN, III, ESQ.,
Counsel for Defendant Arthur W. Sloan

JOHN A. BECK, ESQ.,
Counsel for Defendant James M. Johnston

LOUIS KOUTOULAKOS, ESQ.,
Counsel for Defendants James M. Johnston and Malcolm F. Schoeffel

COURTS OULAHAN, ESQ.,
Counsel for Defendant Franklin C. Salisbury

HARRY L. RYAN, JR., ESQ.,
Counsel for Defendant Presson S. Shane

MILTON V. FREEMAN, ESQ. and
HENRY ST. JOHN FITZGERALD, ESQ.,
Counsel for Defendant Gerald T. Halpin

IRA P. BARSKY, ESQ. and
JAMES W. CROWLEY, ESQ.,
Counsel for Atlantic Research Corp.

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[3] RULING OF THE COURT

The Court: Gentlemen, I first wish to thank you for the helpful way all of you have briefed and argued this case.

I think that there may be a few preliminary remarks before I take up the precise motions before us.

This is a derivative action, and the Court is fuliy in accord with plaintiff's counsel that the motives—as he expressed it—the motives of the parties do not of necessity destroy the action. The Court has considered it on the basis of the pleadings, and holds that merely because the plaintiffs wish to recover their loss, that it does not deprive it of its character of a derivative action. Therefore, all of my subsequent rulings are based on the holding, that we have before us a true derivative action.

Now, that does not mean to say that I have not considered their testimony. I have considered their testimony under the rule of Virginia—that a plaintiff's testimony should be accepted when he offers it, and it binds him. He can rise no higher than it.

We have a number of collateral motions. I think they can be disposed of very briefly.

[4] There has been a Motion to Dismiss on the ground that there is no jurisdiction because the subject matter is before the S. E. C. No authority has been cited to the Court on that, and the Court has found none. That motion is overruled. It appears that this action could be continued concurrently with the action before the S. E. C.

Probably the other collateral motion which should be disposed of at this time is that which was made generally in a number of ways; that is, an improper joinder of the defendants; that Atlantic should be the plaintiff.

In the present posture of this case, the Court believes that Atlantic has been properly joined as a defendant, and that this Court should not realign the parties, which would, of course, have the effect of defeating diversity and, consequently, jurisdiction. The Court believes that the case to which counsel have adverted, while not strictly in point, does set down the rules that governs the Court in this regard.

There have been various motions made that there is not the requisite jurisdictional amount. As counsel for both sides have very frankly stated, that is closely connected with the question of whether this is truly a class suit, a derivative action. The Court having found that it is a derivative action, the jurisdictional amount is present. The motion is denied.

[5] The two principal motions urged before the Court today are that the plaintiffs are not stockholders of record. That is admitted as a fact. It is urged that, consequently, they do not have status to bring this suit. Of course, that conclusion is vigorously opposed.

I considered some time during the morning that possibly it would be well to take this under advisement, write a memorandum on this point and on the point concerning the

demand. But I realize that from the standpoint of the parties, that time is important in this matter. You want to know where you stand. If there are appeals to be taken, they should promptly be taken. It seems to me that the most sensible thing to do under the circumstances is to express my opinions on these matters today, especially since they have been so well briefed and well argued by counsel.

Now, taking up the question of the status of the plaintiffs, there is no doubt that that is to be governed by Virginia law. *Gallup* v. *Caldwell*, 120 F. 2d 90 3rd Cir. (1941) considers this on page 93, where it said:

> "Does the applicable law require that the plaintiff be a stockholder of record? It is established that this plaintiff was not a registered shareholder, at the time the action was begun. The question is not [6] merely a procedural one, such as whether an action may be maintained by the real party in interest who is not the owner of a legal title"—citing Coodrich —"but the substantive one whether one who is not a shareholder of record may assert shareholder's rights either on behalf of or against the corporation. That is a question of the law of New Jersey, the state under the law of which this company was incorporated."

It is established here that this company was incorporated under Virginia law. Counsel advise the Court—I am sure you are correct—that Virginia has not passed upon this question. A stockholder or shareholder, as far as the Court could find, running through the definitions of the Virginia Corporation Act, was not defined as a stockholder of record, although there are many references in that act to a stockholder of record.

The Court understands that the majority rule in the United States is that the plaintiff in a derivative suit such as this need not be a stockholder of record. It is sufficient

if he has equity position. The case cited by the plaintiff, *Rosenthal* v. *Burry Biscuit Corporation*, 30 Del. Ch. 299; 16 A. 2d 106, 1948, commends itself to the Court on this rule. There Chancellor Harrington stated.

> "After an examination of the cases and a weight-
> [7] ing of what I consider to be the reasons behind the diverse opinions, I have concluded that the more reasonable view—which also appears to be the majority view—is one permitting an equitable owner to maintain a derivative action.
>
> "As this court pointed out in *Cantor* v. *Sachs*, 18 Del. Ch. 359; 172 A. 73, a stockholder's derivative suit possesses a double aspect. One aspect is the equivalent of a suit to compel the corporation to sue and the other is the suit by the corporation asserted by the stockholders in its behalf. The former belongs to the complaining stockholders while the latter belongs to the corporation. The action belonging to the corporation possesses the substantial ultimate interest since it involves the merits of the controversy. The interest of the corporation and the equitable stockholders coincided as to this aspect of a derivative action with the consequence that it is not an intra corporate matter as that term is here traditionally employed."

Now, the next paragraph of the Delaware Court's opinion answers quite well the problem that counsel for the defendants have suggested regarding the construction that this Court should put upon the Virginia Corporation Act.
[8] It has been pointed out there are many references to stockholders of record. I think Chancellor Harrington refers to most of them, although, of course, he was not speaking of the Virginia Statute.

> "For many purposes, such as voting, dividend payments, and appraisal proceedings, the corporation must have a rather inflexible basis of stockholder

identity. That rigidity is not needed where the equitable owner is seeking to protect the corporate interests. It places no undue burden on a corporation to permit an equitable owner to sue in such a situation because he must prove his ownership in order to maintain the action, and the need for the same certainty which prompted the courts to recognize only registered stockholders in other situations is therefore not apparent."

And then he goes on to say that his views are in accord with the views expressed by a number of other courts. In fact, he has already indicated that it is the majority rule.

Now, there is no question in this case before this Court that the plaintiffs were the equitable owners of stock. There is no controversy about the amount of stock. There is no question that stock was held in a street account. It has been [9] suggested because the stock was held in a street account, because the rules of the various brokerage houses allow the stock to be hypothecated, brokerage houses may go short, and for other reasons, that the equitable interest in it is destroyed. Well, that, of course, is conduct of the brokerage house inherent in the street name. If, because of these peculiar situations the Court were to hold that a person whose stock might be hypothecated could not maintain an action, it would simply be holding, in other words, that stock registered in a street name could not support such a suit.

It has also been suggested that because of the plaintiffs' margin trading, that there equitable ownership is defeated. Margin trading is a recognized form of trading. The Government approves it, controls it. The fact that stock is purchased on the margin, the Court believes, does not defeat the right to bring a suit such as this.

The Court believes that this is in accord with the majority view, although I must confess that counsel here have

developed the argument much further than most of the cases have developed it. Yet, in its essentials, the issue appears no different from the question whether a person need be a stockholder of record to bring suit.

[10] The Court probably should not concern itself with policy. But much investment money today is in street names. Much of the investment that goes on today is on the margin. This Court would be loathe to rule that in Virginia such a person does not have a right to bring a derivative suit. I doubt if the ruling of the Court would drive investment money from Virginia, but certainly it appears to me that Virginia should be in line with the other large commercial states in the country such as Delaware and New York. That is a question of policy which can be very readily determined by the General Assembly. At the present time they have not acted on it specifically one way or the other.

We come now to the most difficult question, and that is whether the stockholders who have brought this suit have complied with Rule 23(b) of the Federal Rules of Civil Procedure. That rule states in part:

> "The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

Now, it is significant that the rule requires the complaint [11] to be verified, and it is also significant that it says that "the complaint shall set forth with particularity the effort of the plaintiff—" That is a little bit different from the ordinary complaint because our rules ordinarily do not require us to set forth things with such particularity.

Turning to the Meltzer complaint, we find in paragraph 15:

> "Demand upon the board of directors of Atlantic to bring this action would be futile because:
>
> "(a) The board of directors is controlled and dominated by the alleged wrongdoers, through their official positions with Atlantic, and by virtue of their very substantial stockholdings;
>
> "(b) The directors have participated in the wrongs alleged;
>
> "(c) The directors have negligently permitted the aforementioned wrongs to occur and are liable therefor; and
>
> "(d) The institution of this action by the directors would place it in hostile hands and would prevent its effective prosecution."

In the Sterenstein complaint, we find paragraph 8:

> "No demand has been made upon the directors of Atlantic that Atlantic bring this action because [12] such demand would be futile. The members of the Board of Directors approved of and acquiesced in such wrongs, and personally benefitted thereby. They would not and could not have diligently prosecuted this action."

The Court has considered those allegations, all of the testimony of the plaintiffs and the letter to the stockholders which was brought to the attention of the Court by counsel for the plaintiff in his pretrial memorandum. Plaintiffs' counsel has asserted that the letter sets forth a great deal of the issues raised in the suits and that the plaintiffs rely upon the matters set forth in the letter to disclose the wrongdoings

The plaintiffs have relied primarily upon two of the leading cases. Certainly, one of them is the leading case—*Delaware & Hudson Company* v. *Albany & Susquehanna Railroad*, 213 U.S. 435.

Gentlemen, let me say, parenthetically, that I am not going to attempt to recite all of the cases which you have mentioned. In stating that you rely upon a case, I do not mean to in any way foreclose you. You have cited many cases in your brief, and they have been very helpful. But I tried to pick out those cases which I thought fairly typified the position that you took.

[13] That case sustains, to a great extent, the argument made by the plaintiff. Of course, at that time the rule did not say that you should set forth with particularity the reason for failing to make the demand. That was added, possibly, as a result of that case. The Court believes, however, that the case is not controlling.

Facts were certified to the Court in that case, and among those facts was:

> "So far as appears from anything shown in this record none of the directors or officers of the Delaware Company ever, before or after the bringing of this suit, treated the claim therein set forth otherwise than as one of doubtful validity the payment of which was to be resisted."

Of course, this is a case that involves an interlocking directorship, so that does appear among the factors. We do not have that factual situation, in the opinion of the Court, in the case at bar.

Another case mentioned by the plaintiffs, and which is a very helpful case, is *Cohen* v. *Industrial Finance Corporation*. I should say it is mentioned by both parties. It runs throughout your briefs. 44 F. Supp. 491, Southern District of New York, 1942. There, the Court said, on page 494:

[14] "A realistic view should be taken of the facts pleaded as excusing a demand on directors that they bring suit. The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder, after accusations of wrongdoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority. Where we know that puppet directors would at best only go through the motions, are we barred from considering who would be manipulating the wires? As stated in the Delaware & Hudson case, supra, the rule 'is intended to have practical operation, and to have that it must, as to its requirements, be given such play as to fit the conditions of different cases.'

"Whether or not a demand is excused in a particular case is a question for the court. In passing upon that question the Court should consider the whole complaint, not merely the paragraph in which the pleader summarizes his reasons for not demanding action by the directors or stockholders."

[15] Now I think, parenthetically, I should make it plain here so the record will be clear as to what I have done. This is a rather unique situation. Certainly, it is in this jurisdiction. Counsel have not cited any Fourth Circuit cases that are controlling. I have not only considered the complaint, but, as I have said before, I have considered the testimony of the plaintiffs and the letter to the stockholders which the plaintiffs have called to my attention and the statements in their briefs and the oral argument pertaining to the importance of that letter. So I have gone a little bit further than the Cohen case in considering the pleadings and evidence.

The Court in the Cohen case goes on to say:

> "I am of the opinion that the allegations of the complaint are adequate within the concept of Rule 23(b). Here the corporate directors of 'Acceptance' are alleged in effect to be mere 'dummies' for 'Finance.' Further the complaint shows that their interests and the interests of those who named them are antagonistic to the interest of 'Acceptance.' It is alleged that these directors 'have had knowledge of all the acts complained of herein and have acquiesced and participated therein.' It is also alleged that 'Finance,' one of the participants in the profits of the illegal transaction owns or controls 85% to [16] 90% of the common stock of 'Acceptance,' and has voting control of 'Acceptance.' The requirement of a demand should be dispensed with, where it is clear that a demand would be a useless gesture. Indeed, in cases such as this, where other representative actions by stockholders have been 'settled,' against the real interests of the injured corporation, it would be the height of folly to entrust the conduct of the litigation, either directly or indirectly, to the very people who are responsible for the wrongs, according to the complaint.
>
> "The present director of 'Acceptance,' with full knowledge of the facts, for years, have done nothing to protect the interests of that corporation, as the complaint alleges."

Again, the Court is of the opinion that the facts in that case do not coincide with the facts that we have before us. Of course, facts never coincide, but in their controlling features, in their most important phases they do not reach the situation, or are not comparable, to the situation that we have here.

Now, again, there are any number of cases, which have been cited for the other side in this situation. There are [17] Virginia cases. There are a number of Federal cases about the demand. I am not going to try to comment upon all of them. I would like to remark about *Levitan* v. *Stout*, 97 F. Supp. 105, W. D. Ky. (1951). I mention this because it has influenced my thinking about this case. I specifically asked counsel for the plaintiffs to advise me about it, which he did, and I appreciated it.

Now, that case has some factual situations similar to that which we have here. Mr. Lobell has drawn a distinction between that case and this case, which in many respects is valid. The case does, as he pointed out, concern primarily business ventures; and, as Mr. Boothe pointed out, one of them is the bourbon venture. There are other matters, however, concerning the employment contracts which the stockholders alleged were not proper.

There, the principal directors and stockholders controlled about 40% of the stock, which is very close to what we have today; and there, it was alleged:

> "* * * that demand on the Board of Directors would have been futile because three of the six directors who were in office at the commencement of the action are defendants herein and presumably would not authorize action against themselves, or permit such an action to be vigorously prosecuted [18] if it were instituted. It is alleged that demand on the stockholders of the corporation would have been futile because the stockholders, as such, have no authority to require the Corporation to commence legal action because ownership of the 60% of stock not held by defendants is scattered; and because a proxy fight, under the circumstances, would have imposed a great financial burden on the plaintiffs."

The Court says, at page 113:

"An additional reason for granting the motion to dismiss is that the plaintiffs have failed to exhaust their corporate remedies as required by Rule 23(b) of the Rules of Civil Procedure. As has been stated above, the plaintiffs have made no effort to induce the directors or stockholders of the Corporation to bring suit. Instead, they have endeavored to demonstrate that any efforts along this line would have been futile.

"In appraising the sufficiency of the allegations on this point, the Court must take account of the fact that, for all that appears in the record, it would have been a very simple matter for the plaintiffs to make demands upon the directors and shareholders. This could have been done, for example, by simply [19] mailing a copy of the complaint to the Board of Directors with a letter advising them that unless the Corporation enforced its rights within a reasonable time, the plaintiffs would undertake to do so on its behalf. If the Board of Directors had failed or refused to take action, the plaintiffs could have appeared at the next annual meeting of stockholders, presented a copy of the complaint, and urged the election of directors who would cause the Corporation to bring suit. • • •"

"It is well established that the courts will not take jurisdiction over intra-corporate disputes unless the ordinary corporate procedures are for some reason frustrated. "• • • A stockholder, in taking stock in the ordinary corporation, submits, within the charter limits, to a guidance of the corporate affairs according to the will of the owners of a majority of the stock and through the directors whom the majority choose. The minority have a right to have the majority exercise their judgment, and to exercise it honestly and not fraudulently, but have no right to have a court substitute their own ideas and wishes for those of the

majority, and that in advance of any refusal of the majority to hear [20] and decide on the matter at issue. Minority stockholders may not in the absence of sudden emergency ask a court of equity to interfere in the management of their corporation until they have earnestly and unsuccessfully sought redress from the Board of Directors, and where appropriate also from the stockholders in meeting, unless they can show sufficient reasons for not doing so.' "

Then the court goes on to say, at the bottom of page 114:

"Turning now to the allegations of the amended complaint in the present case, this Court must decide whether such allegations demonstrate the futility of a demand on the Board of Directors and stockholders. In the opinion of this Court, they do not. The central question is whether the ownership of 40% of the voting stock of a corporation is, as a matter of law, so clearly equivalent to full power over the Board of Directors that the directors will obey the orders of the owners of said stock—even in contravention of their own duty to act for the best interest of the corporation and despite their own responsibility for failure to do so. This Court cannot bring itself to such a conclusion."

[21] Now, in fairness to the plaintiffs, it should be stated here that there are allegations of more than the simple control. It goes further in this case, and that is one of the things that makes this particular suit rather difficult. Quoting again from *Levitan:*

"To be sure, there are conclusory allegations to the the effect that the defendants Stout and Dulaney dominated and controlled the Board of Directors, and that by reason of the scattered holdings of the other stockholders the defendants Stout and Dulaney had effec-

tive power to elect a majority of the Board of Directors."

Then the Court goes on to discuss the orderly and just procedure that Rule 23(b) sets forth and the reasons that the rule has been made.

We turn now to the peculiar situation in this case, that is the remedial action that has already been taken, the plaintiff's testimony and the interweaving aspects of those two things.

Without going into detail about dates, I think it is a fair statement to say that almost simultaneously with the preparation of the suits, the Board of Directors had under consideration the remedial action. How long they were under consideration by both parties, we do not know. We [22] do know that they appeared almost at the same time. The remedial actions is stated in full in the exhibit which plaintiffs have filed, under the title "Special Report to Stockholders of the Atlantic Research Corporation." Probably the most important steps that the Board took were:

To increase the Board of Directors by authorizing two new outside directors; authorizing an executive committee of three members of the Board, two to be outside directors and one of them an officer of the corporation. Dr. Arthur W. Sloan was made chairman and Rear Admiral Malcolm F. Schoeffel and James M. Johnston became the outside members. It named as general counsel the firm of Frost & Towers in Washington; arranged to retain the accounting firm of Price, Waterhouse & Co.; resolved to find a person well-versed in corporate finance; and took action respecting pledges to secure bank loans referred to in Note 13 to the Financial Statements.

These matters, I think, are also summarized and fairly stated in the Preliminary Statement filed by the defendants on page 14 and 15. It is not controverted that the power of the president was drastically curtailed. The Board

removed the President of the Company. It did assign him the position of Chairman of the Board, and it did obtain from Dr. Scurlock and Dr. Sloan a guarantee of certain [23] outstanding loans.

Now, where this case becomes unique is that this activity was going on at the time that the plaintiffs were preparing their suits. For that reason, the question of demand becomes particularly important in this case, the Court believes.

We turn to Mr. Meltzer's testimony. He has a great deal of testimony to which I am not going to advert. It does not mean that I do not believe it, but I am just going to pick out one part it appears to me is pertinent and unusual in this suit.

Speaking of this Special Report, Mr. Meltzer was asked a question on page 28 of the deposition:

> "When you read this report, didn't it outline remedial action which the Corporation said it had taken? A. Yes.
>
> "Q. Wasn't it the same remedial action that you are requesting in your lawsuit? A. I don't know. I am not sure. I didn't pay too much attention to it."

Now, it appears to the Court that if this plaintiff can say that he does not know whether the remedial action is all that he wanted, it ill behooves him to come into the [24] court and ask the Court to tell him.

Now, casting that within the framework of Rule 23(b), it appears that there is great possibilty that if he had followed Rule 23(b) in asking for the remedial action, that even if additional remedial action were not forthcoming, he might have been satisfied in what did take place.

It also is reasonable to speculate—and it is only speculation—that if he had called other matters to the attention of the Board while they were in a reform mood, so to

speak, they may have followed his suggestions. Certainly, we have not a situation here that the *Delaware & Hudson* case had. There it was certified: "So far as appears from anything shown in this record none of the directors or officers of the Delaware Company ever, before or after bringing this suit, treated the claim therein set forth otherwise than as one of doubtful validity • • •."

Here the Board has given this matter some concern.

Now, it is true, the Court recognizes, that the Board has not given all of the relief that the plaintiff seeks, but that is not the question before us on this motion. The question is whether Rule 23(b) has been complied with, or whether the allegations set forth are sufficient to excuse [25] the effort.

It also demonstrates that the situation is not the same as that in the Cohen case where the evidence was that the directors, with full knowledge of facts, for years had done nothing to protect the interest of the corporation, as the complaint alleges. In that case also, there have been other demands made by other stockholders.

Now we come to Mr. Sterenstein's testimony, and he is essentially in the same position as Mr. Meltzer, but he cannot say, for a very good reason, whether the remedial action taken would have been satisfactory to him. He was asked on page 46—the question was:

> "I am speaking of demand upon this Corporation or its stockholders or directors. A. I made no demands, no sir.
>
> "Q. Did you receive a special report from the Corporation with respect to the S.E.C. Investigation? A. To the best of my recollection, I did not receive it.
>
> "Q. Have you ever seen it? A. I do not think I did see it."

Now these complaints were probably prepared before the report. Counsel may be able to help me on that. I

[26] do not want to misstate any facts, but as far as I can determine, these things must have been going along fairly simultaneously. Certainly, the suit had been filed by the time that Mr. Meltzer saw the report.

Now, Mr. Sterenstein is essentially in the same position, and Mrs. Sterenstein.

He cannot say whether the action which he sought would have been better or not, or whether it has been met. Of course, I make this comment upon the testimony with full realization that they are still prosecuting the suit, but in making that comment I must also take into consideration that they have said time and again that they know very, very little about this, and they have left it up to their attorneys. It was the duty of the attorney to prosecute the suit diligently. But the Court cannot measure the plaintiff's rights by the action of the attorneys.

Counsel have urged me to rule on the question of whether the plaintiffs should have made a demand upon the stockholders. The Court believes that it is impossible to rule at this time because of the absence of a demand upon the directors. It is impossible to say whether or not a demand upon the stockholders should or should not have been made until the plaintiffs had gotten their answer from the directors. The Court believes that that is the fair [27] purport of that rule.

The Court believes that the rule which states, "and, if necessary, from the shareholders," means that they should apply to the shareholders if they had not gotten results from the directors. So the Court is not going to rule at this time. There is nothing to rule on.

The Court is of the opinion that Rule 23(b) has not been complied with.

Now, we have some other motions, and they pertain to service of process. As counsel have frankly stated, those motions are interwoven with whether the complaint states

a cause of action. We did not get into the motion on process in the way I would like to have it gone into in order to rule on it. Mr. Morgan stated he never heard of the exact basis of the complaint until Mr. Lobell spoke about it in what was essentially rebuttal argument. Then Mr. Morgan wanted me to take into conside tion a case which was not cited and which Mr. Lobell had no opportunity to read and comment upon. I just do not like to decide cases that way. Because of the peculiar situation in which we find ourselves, I think we will defer ruling on that. It is not necessary for the disposition of this case. If the case should come back to me, why, of course, we will have to rule on it. I must confess I did not realize how closely it was tied [28] with whether or not the complaint states a cause of action until I heard the oral argument today. I have not considered the case which Mr. Morgan says is controlling. I will not consider it unless Mr. Lobell has a chance to tell me it is not controlling.

I think what I have said disposes of the case. What I have tried to do is rule on the most important motions so if counsel wish to assign error and cross-error they may do so.

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IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

Civil Action No. 2787

SAMUEL MELTZER, *Plaintiff*,

v.

ARCH C. SCURLOCK, et al. *Defendants*.

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* * *

Order of the District Court

These causes having been consolidated for the purpose of hearing all motions by Order entered by the Court on February 1, 1963, came on upon the motions theretofore filed to be heard by the Court on Wednesday, May 29, 1963, the parties being present by counsel, the Plaintiffs all being represented by Nathan D. Lobell, Esquire, and George Giammittorio, Esquire, and all of the Defendants being represented by their respective counsel of record except Defendants Stuart L. Bailey, M. Lee Rice and Keith E. Rumbel, whose counsel, Robert Hirsch and Stanford E. Parris had filed responsive pleadings but who waived the privilege of attending the argument of the motions; whereupon the motions were argued by counsel for the Plaintiffs and for the Defendants, the said arguments being transcribed by the Court Reporter of this Court; and at the conclusion of all arguments the Court did recess the proceedings and upon convening, the Court after recess did hand down an opinion which was transcribed; and, for the reasons set forth in the said opinion,

It is ADJUDGED and ORDERED by the Court as follows:

1. The motions to dismiss on the ground that the subject matter of the actions is currently involved in a pro-

ceeding before the Securities and Exchange Commission, be and the same hereby are denied.

2. The motions to dismiss on the ground that Defendant, Atlantic Research Corporation is not a proper party Defendant, that the parties should be realigned and that Atlantic Research Corporation should be made a party Plaintiff, be and the same hereby are denied.

3. The motions to dismiss on the ground that the jurisdictional amount of $10,000.00 or more is not involved in these actions, be and the same hereby are denied.

4. The motions to dismiss on the ground of the lack of Plaintiffs' capacity to sue and on the ground that the Plaintiffs have no standing to maintain these actions because they are not stockholders of record, be and the same hereby are denied.

5. The motions to dismiss on the ground that Plaintiffs had failed to comply with Rule 23(b) of the Federal Rules of Civil Procedure as far as the Directors of Atlantic Research Corporation were involved, be and the same hereby are granted and these causes of action are hereby dismissed without prejudice.

6. The motions to dismiss on the ground that the Plaintiffs had failed to comply with Rule 23(b) of the Federal Rules of Civil Procedure insofar as the stockholders of Atlantic Research Corporation were involved, be and the same hereby are deferred.

7. The motions to dismiss on the ground of insufficiency of service of process, be and the same hereby are deferred.

8. Oral motion made by counsel for the Plaintiffs that the Court consider demand upon the Directors of Atlantic Research Corporation as made at that time and that the Court proceed to hear the causes on their merits, be and the same hereby is denied.

9. Counsel for the parties having excepted to all of the respective adverse rulings of the Court, such exceptions be and they hereby are allowed.

Entered this 19 day of July, 1963:

/s/ JOHN D. BUTZNER, JR.
John D. Butzner, Jr.
United States District Judge

* * *

Opinion—Filed and Entered April 9, 1964

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 9201

SAMUEL MELTZER, *Appellant*,

v.

ATLANTIC RESEARCH CORPORATION, et al., *Appellees*.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA, AT ALEXANDRIA.
JOHN D. BUTZNER, JR., DISTRICT JUDGE.

(Argued January 23, 1964. Decided April 9, 1964.)

Before BRYAN and BELL, Circuit Judges and MICHIE, District Judge.

Sidney B. Silverman (Ewell C. Moore, Jr., Rutherford Day and Rosenfield & Silverman on brief) for Appellant, and Armistead L. Boothe (James W. Crowley, Ira P. Barsky, Louis Koutoulakos, John A. Beck, Charles S. Rhyne, Thomas P. Brown, III, Ganson Purcell, E. Ladd Thurston and Courts Oulahan on brief) for Appellees.

ALBERT V. BRYAN, Circuit Judge:

This derivative suit by shareholder Samuel Meltzer against the Atlantic Research Corporation and its then five directors was dismissed by the District Court on the ground that the plaintiff had failed first to demand of the directors "such action as he desires" of the corporation—that is to sue for recovery of losses it suffered from the alleged misfeasance or nonfeasance of the directors. This exaction of the plaintiff was predicated on Rule 23(b), Fed.R.Civ.P. reading pertinently as follows:

> "The complaint [in a secondary action] shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

Appealing, the shareowner contends that a demand would have been in vain and, indeed, ineffectual if granted. We agree.

The complaint was filed on behalf of all the other shareholders. As the decision was passed on a motion to dismiss or for summary judgment, the allegations of the plaintiff are to be treated as admitted or as not genuinely in issue. So taken, they depict such misfeasance by two directors—Arch C. Scurlock and Arthur W. Sloan—and such nonfeasance by the other three as to demonstrate the emptiness of resort to them.

Scurlock and Sloan, according to the complaint, own 418,790 and 372,530 shares of Atlantic's common stock, that is 21% and 18%, respectively. It further averred that together with the other three defendant directors, Scurlock as director and president, and Sloan as vice-president and director, dominated Atlantic.

Plaintiff, a beneficial holder of stock since 1960, commenced the present action on November 13, 1962 and on

January 3, 1963 filed an amendment, here treated as the complaint. He charges that on October 10, 1962 the Securities and Exchange Commission suspended the trading of Atlantic's stock on the American Stock Exchange because of the publication by Atlantic of false financial statements, including the failure to disclose certain unauthorized diversions of corporate moneys.

The misapplications were alleged as committed in 1962 and prior years. The first was the loan of $3,900,000 by Atlantic at the instance of Scurlock to "certain intermediaries". The censure is: that he had borrowed upon nearly all of his stock in Atlantic; that the market price of this stock began to decline sharply in June 1961; that as the price fell the value of the investment of the individual defendants decreased; and that in order to prevent further dwindling of their investments and to prevent shrinkage of Scurlock's security for his loans, with possible foreclosure by sale of his Atlantic shares, Scurlock and the other defendant directors determined to support the market price of Atlantic's shares. This was accomplished, the complaint declares, through the loans of $3,900,000, as the intermediaries were to use the proceeds to buy Atlantic shares on the market. This process was completed with the pledge of the newly purchased shares to Atlantic as security for the notes representing the $3,900,000.

In addition to citing Scurlock as using Atlantic's funds to defray his living, entertainment and personal traveling expenses, the complaint goes on to tax him and the other defendant directors with financing other companies in which Scurlock and Sloan were largely interested; and that these funds were used to acquire and improve land of these companies which in turn leased them to Atlantic on unfavorable terms. The complaint submits that all of these transactions were effected or brought about by Scurlock and Sloan and were participated in, or negligently tolerated by, the other defendant directors.

Injury to Atlantic is summarized in this way: that the false publication with resulting suspension by the S.E.C. of market trading in its shares gravely impaired the credit of Atlantic; that the security for the loans of $3,900,000 is substantially less in value than their face amounts; that the loans were illegal, as they were made by Atlantic to acquire its own stock; that this employment of these moneys—said to be 20% of its total assets—withdrew that sum from the intended aims of the corporation; and that these loans, as well as the appropriation of Atlantic's funds to the use of the other companies in which Scurlock and Sloan were interested, constituted "a waste and spoliation of Atlantic assets".

None of the acts or apathy of the defendants as pleaded was denied. The defense is that the directors have taken all the rehabilitative measures which could be required of them by the corporation, and this action proves the wisdom of the prerequisite of a demand before suit. The only denial is the averment of the insecurity of the loans of $3,900,000.

In this background, demand of the directors that the corporation recapture these loans and appropriations, as well as recover damages suffered by the corporation, would have been utterly unavailing. The plaintiff points out that Scurlock and Sloan with the other defendant directors dominate the Board, for they were the Board. It was too much to expect that the Board would direct the corporation to sue themselves. Furthermore, such a suit, as the plaintiff asks, would be controlled by the Board and for this reason it is artless indeed, and faithless to the corporation, to leave the prosecution of it to the defendants therein. Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 88 (2 Cir. 1955), 251 F.2d 340 (1957). This is demonstrated by the fact that they have already caused the corporation itself to join in the strenuous defensive moves in this suit. *Cf.* Liggett v. Roanoke Water Co., 126 Va. 22, 101 S.E. 55, 57 (1919).

The necessity and sufficiency of the preliminary demand upon the directors, and the circumstance which satisfies omission of such demand, under Rule 23(b) would seem to be procedural in nature and hence governed by Federal law. See Delaware & Hudson Co. v. Albany & Susquehanna R.R., 213 U.S. 435, 451 (1909); Quirke v. St. Louis-San Francisco R.R., 277 F.2d 705 (8 Cir.), *cert. denied*, 363 U.S. 845 (1960); but see Steinberg v. Hardy, 90 F.Supp. 167 (D.Conn. 1950). In any event, Virginia decisional law appears to be in accord. In Liggett v. Roanoke Water Co., *supra*, 126 Va. 22, 101 S.E. 55, the Court declared:

> "[U]nder the well-established and admitted doctrine . . . a stockholder may maintain such a suit for a wrongful diversion of the assets of a corporation if he alleges and proves that a request or demand has been made upon the board of directors, or other body managing the corporation, to institute proceedings against the wrongdoer, and that they have refused to do so after a reasonable request or demand, or upon the allegation and proof of such facts as shown that it is reasonably certain that a demand for corporate action would have been useless".

On the allegations of the complaint, the plaintiff is certainly also to be forgiven the omission of a request upon the stockholders to force restoration of Atlantic's losses. While the District Court did not reach that point, we see at once the futility of any such importunity upon the shareholders. With Scurlock and Sloan holding 40% of the voting stock, even without consideration of the stock holdings of their associates, it would be costly business in time and money for the smaller holders to compel the corporation to protect its rights. The stock is widely distributed and the convening of a sufficient number of the remaining 60% for a discussion and vote would certainly not be readily feasible. *Cf.* Delaware & Hudson Co. v. Albany & Susquehanna R.R., *supra*, 213 U.S. 435, 451.

In defense, as already noted, the directors maintain that demand upon them would have achieved all of the aims of the present plaintiff. For proof they refer to the redemptive action of the Board upon learning of S.E.C.'s accusation. But this was severely wanting in satisfaction. The first step of the Board was to authorize two additional directorships, 7 instead of 5. The two directors to be added were persons not already within the corporation. However, their selection was left to the very persons now sued. The immediate result was only remotely remedial. Next, the Board authorized the creation of an executive committee consisting of three members and removed Scurlock as president. But he was immediately elected Chairman of the Board. At once Sloan was made president and the "chief executive authority over the corporation" was placed in him. Thus the very persons of whom complaint was made were retained in top rank positions.

Apart from employing a law firm to act as general counsel for the corporation, procuring a reputable accounting firm, and circulating financial statements, the only other reconstructive action of the Board was to obtain guarantees from Scurlock and Sloan of the outstanding loans of $3,900,000. These notes were impliedly admitted to be of doubtful value by the new accountant's requirement that a reserve be set up against their loss. The damage done by the loans of $3,900,000 is not cured by the guarantee of Scurlock and Sloan. Such misdirection of company funds is cured by not less than the immediate return of the money to the corporation. The action of the Board ratifies the loans rather than repudiates them. In oral argument we are told that the guarantee of Scurlock is of little value because of encumbrances upon his assets.

Again, if the defendant directors other than Scurlock and Sloan did approve these loans or were derelict in discovering or recognizing and opposing them, the corporation undoubtedly has a claim against them for any resulting loss. O'Connor v. First Nat. Investors' Corporation, 163

Va. 908, 177 S.E. 852 (1935). All of this applies with equal force to any channeling of corporate money into other companies.

Virginia decisional law acknowledges and upholds a cause of action on the facts alleged by the appellant. Liggett v. Roanoke Water Co., *supra*, 126 Va. 22, 101 S.E. 55. This right of a minority stockholder has long been elementary in the Federal courts too. Delaware & Hudson Co. v. Albany & Susquehanna R.R., *supra*, 213 U.S. 435, 451. We do not intend to hold that the charges in the complaint are true. The only question before us is whether the facts well pleaded there excused the plaintiff from a prefatory demand upon the directors and stockholders. To repeat, we think they do.

The judgment of dismissal must be reversed, and the action remanded for trial.

Reversed and Remanded.

Judgment

Filed and Entered, April 9, 1964.

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 9201

SAMUEL MELTZER, *Appellant*,

v.

ATLANTIC RESEARCH CORPORATION, ET AL., *Appellees*.

Appeal from the United States District Court for the Eastern District of Virginia.

This cause came on to be heard on the record from the United States District Court for the Eastern District of Virginia, and was argued by counsel.

On considetation whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court appealed from, in this cause, be, and the same is hereby, reversed with costs; and that this cause be, and the same is hereby, remanded to the United States District Court for the Eastern District of Virginia, at Alexandria, with direction to grant a trial in accordance with the opinion of the Court filed herein.

ALBERT V. BRYAN,
United States Circuit Judge.

J. SPENCER BELL
United States Circuit Judge.

THOMAS J. MICHIE
United States District Judge.